

1 Simultaneously with the issuance of this Order the Commission released a Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the Nasdaq Market (the "Report"). The findings made herein are solely for the purpose of this (continued...)

## II.

Accordingly, IT IS HEREBY ORDERED, that proceedings pursuant to Section 19(h) of the Exchange Act be, and they hereby are, instituted.

## III.

On the basis of this Order and the Offer of Settlement submitted by the NASD, the Commission finds that:

### A. RESPONDENT

The NASD is a Delaware nonstock corporation which is and at all relevant times was registered with the Commission as a national securities association pursuant to Section 15A(b) of the Exchange Act. At all relevant times, the NASD operated the Nasdaq Stock Market, Inc. ("the Nasdaq market"), an over-the-counter securities market featuring the electronic display of dealer price quotations. In January 1996, the NASD incorporated NASD Regulation, Inc. ("NASDR") as a wholly owned subsidiary to be delegated day-to-day responsibility for the self-regulatory operations of the NASD.

### B. MISCONDUCT IN THE NASDAQ STOCK MARKET

The Nasdaq market has not always operated in an open and freely competitive manner. Nasdaq market makers have engaged in conduct which has resulted in artificially inflexible spreads between dealer price quotations for many Nasdaq securities and unduly disadvantageous prices to investors trading in those securities. A number of Nasdaq market makers have also taken action to discourage competition. At the same time, various Nasdaq market makers have coordinated price quotations, transactions and transaction reports in order to protect or advance their proprietary interests, to the detriment of investors and other market participants. Many Nasdaq market makers have also failed to satisfy their basic obligations to transact at quoted prices and to report transactions in a timely and accurate manner. These activities involved potentially serious violations of NASD rules and the federal securities laws.

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<sup>1</sup>(...continued)

proceeding and are not binding on any other person or entity named as a respondent or defendant in any other proceeding. Moreover, the findings made herein do not affect the NASD's rights in any respect as to parties other than the Commission.

### **C. THE NASD'S PERFORMANCE AS A SELF-REGULATORY ORGANIZATION**

The Exchange Act requires the NASD, as a self-regulatory organization, to comply with, and vigorously enforce, in an evenhanded and impartial manner, the provisions of the Exchange Act, the rules and regulations thereunder and its own rules, in carrying out its role as the entity responsible for the day-to-day oversight of its members and the Nasdaq market.<sup>2</sup> The NASD has an affirmative obligation to be vigilant in surveilling for, evaluating, and effectively addressing issues that could involve violations of such provisions.

The NASD, during the period covered in the Report, did not comply with certain of its rules or satisfy its obligations under the Exchange Act to enforce its rules and the federal securities laws. It has inadequately enforced rules applicable to market makers while applying, in certain cases, ad hoc standards and criteria not embodied in NASD rules. This is attributable, in part, to the undue influence of Nasdaq market makers in the regulatory processes of the NASD. As a result of these regulatory failures, the NASD has violated the duties imposed on it by the Exchange Act.

#### **1. THE NASD'S INADEQUATE RESPONSE TO MISCONDUCT IN NASDAQ**

By 1990, the NASD was aware of information suggesting that its members were engaged in misconduct which had potential anticompetitive implications and could be detrimental to the interests of investors. This information included: (a) facts and circumstances evidencing a convention among dealers that resulted in many stocks being quoted almost invariably in even-eighths; (b) evidence of spreads and dealer quotations being artificially inflexible with market makers having little incentive to narrow them; and (c) facts indicating that some market makers retaliated against other market makers who attempted to improve upon quotations otherwise prevailing in the market. The NASD failed to take appropriate action to thoroughly investigate these problems and take effective regulatory action. In particular, the NASD did not utilize the NASD's surveillance and enforcement resources to inquire into the conduct of market makers to ascertain whether violations of the NASD's rules or the federal securities laws had occurred and whether disciplinary action against market makers for such conduct was warranted.

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<sup>2</sup> Sections 19(g) and 19(h) of the Exchange Act, 15 U.S.C. §§ 78s(g) and 78s(h).

## **2. FAILURE TO ENFORCE FIRM QUOTE RULE**

Market makers on Nasdaq have the obligation to trade at their quotations.<sup>3</sup> Many market makers, however, have repeatedly failed to honor their quotations even though no exception was available. The NASD is required to enforce the market makers' obligation to trade at their quotations, but has failed to adequately enforce compliance by market makers with this obligation.

## **3. FAILURE TO ENFORCE TRADE REPORTING RULE**

Market makers on Nasdaq have the obligation to report transactions on a timely and accurate basis.<sup>4</sup> Many market makers, however, have repeatedly failed to report transactions on a timely and accurate basis. The NASD is required to enforce the market makers' obligation to report transactions on a timely and accurate basis, but has failed to adequately enforce compliance by market makers with this obligation.

## **4. FAILURE TO COMPLY WITH RULES RELATING TO NASD MEMBERSHIP**

The NASD processed the applications for membership of certain firms in a manner inconsistent with its rules. It

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<sup>3</sup> The firm quote rule is Exchange Act Rule 11Ac1-1, 17 C.F.R. § 240.11Ac1-1 (1996), and similar requirements are found in the NASD's rules. NASD Manual, Article III, Rules of Fair Practice, § 6, and NASD Bylaws, Schedule D, Part V, § 2(b) and Part VI, § 2, (CCH) ¶¶ 1819, 1829 and 2156 (1995). These rules require that market makers trade up to the amount of their quotations at whatever prices they have posted. Market makers are excepted from this duty only if (1) they change a quotation before receiving an order, or (2) they are in the process of executing a transaction when they receive an order, and send a new quotation to the Nasdaq immediately upon executing that transaction.

<sup>4</sup> Pursuant to Rules 11Aa3-1 and 11Aa3-2 under the Exchange Act of 1934, 17 C.F.R. §§ 240.11Aa3-1 and 11Aa3-2, the NASD adopted a transaction reporting plan for National Market System securities in 1982. Securities Exchange Act Release No. 18590 (March 31, 1982), 47 Fed. Reg. 13617. As part of this plan, transactions in designated Nasdaq securities must be reported within 90 seconds after execution. NASD Manual, Schedule D to the By-Laws, Part X, § 2(a), (CCH) ¶ 1867 (1995).

required such applicants to satisfy criteria not enumerated in the rules, failed to process their applications within a reasonable time, placed improper restrictions on their activities as a condition to membership, and prevented such members, once admitted, from seeking modifications to their restriction agreements as permitted by the NASD's rules.<sup>5</sup>

#### D. CONCLUSION

Based upon the foregoing, the Commission finds that during the relevant period the NASD has failed to comply with certain NASD rules and, without reasonable justification or excuse, failed to enforce compliance with the Exchange Act, the rules and regulations thereunder and its own rules, in violation of Section 19(g) of the Exchange Act.<sup>6</sup>

The NASD has represented that in conjunction with the undertakings set forth below and other remedial measures it has taken and will take, the Board of Governors of the NASD and the Board of Directors of NASDR have authorized \$25 million and have committed to expend an additional \$75 million over the next five years, to enhance its systems for market surveillance, including the development and implementation of an enhanced audit trail, and to increase its staffing in the areas of examination, surveillance, enforcement, and internal audit.<sup>7</sup>

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<sup>5</sup> The rules relating to membership applications are set forth in the NASD By-Laws. NASD Manual, Schedule C to the By-Laws, Part I (CCH) ¶ 1783 (1995). This Order makes no findings as to the NASD's processing or final determination of any specific membership application.

<sup>6</sup> Among other things, the NASD failed to take appropriate investigative and enforcement action with respect to possible violations of Sections 10(b), 11A and 15(c) of the Exchange Act, and Rules 10b-5, 11Aa3-1(c), 11Ac1-1(c) and 15c1-2 promulgated thereunder, and certain of the NASD's rules, including Article III, § 1 of the NASD's rules of Fair Practice, NASD Manual (CCH) ¶ 2151 (1995), the NASD's rules regarding the firm quote obligations of market makers, NASD Manual, Article III, Rules of Fair Practice, § 6, and NASD Bylaws, Schedule D, Part V, § 2(b) and Part VI, § 2, (CCH) ¶¶ 1819, 1829 and 2156 (1995), and the NASD's rules regarding trade reporting, NASD Manual, Schedule D to the By-Laws, Part X, § 2(a), (CCH) ¶ 1867 (1995).

<sup>7</sup> These funds are in addition to 1995 funding levels for these activities. If, over the course of this time period, the Board of Governors of the NASD and the  
(continued...)

In recognition of this commitment, the Commission has determined not to seek a monetary penalty from the NASD.

IV.

In view of the foregoing, it is in the public interest to impose the sanctions specified in the NASD's Offer of Settlement.

Accordingly, IT IS HEREBY ORDERED THAT:

A. The NASD be, and hereby is, censured.

B. The NASD shall comply with the following undertakings within the next twelve months (or within such other time period as is otherwise noted below):

1. To implement and maintain at least fifty percent independent public and non-industry membership in its Board of Governors, the Board(s) of Governors or Directors of all of its subsidiaries and affiliates that exercise or have delegated self-regulatory functions, and the following committees: the National Nominating Committee, the Trading/Quality of Markets Committee, the Arbitration Committee, the Market Surveillance Committee, the National Business Conduct Committee, the Management Compensation Committee, and all successors thereto.
2. To provide that NASDR and any successor thereto has, consistent with the NASD's By-Laws and Plan of Delegation, as amended from time to time and as approved by the Commission, primary day-to-day responsibility for the regulation, surveillance, examination and disciplining of NASD member firms and registered persons, with respect to market activities as well as other self-regulatory matters, with full access to the records of the Nasdaq market.
3. To institute the participation of professional hearing officers (who shall be attorneys with appropriate experience and training) to preside over disciplinary proceedings.

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<sup>7</sup>(...continued)

Board of Directors of NASDR believe that the \$100 million expenditure is not achievable or feasible, the NASD may, by application to the Commission, seek modification of this commitment.

4. To provide for the autonomy and independence of the regulatory staff of the NASD and its subsidiaries such that the staff, subject only to the supervision of the Board of Governors of the NASD and the Boards of Directors of NASDR and Nasdaq, and any successor thereto, (a) has sole discretion as to what matters to investigate and prosecute, (b) has sole discretion to handle regulatory matters such as approval of applications for membership and the conditions and limitations that may be placed thereon, (c) prepares rule proposals, rule interpretations and other policy matters with any consultations with interested NASD constituencies made in a fair and evenhanded manner, and (d) is generally insulated from the commercial interests of its members and the Nasdaq market. Among other things, the District Business Conduct Committees and the Market Surveillance Committee shall not have any involvement in deciding whether or not to institute disciplinary proceedings, nor shall the District Committees, or any subcommittee thereof, have any involvement in the review or approval of applications for membership in the NASD. Subject to the foregoing, the regulatory staff of the NASDR engaged in the disciplinary process may, solely on their own initiative, inform themselves on matters of market or other securities industry expertise by consulting with representatives of member firms or committees of the NASD or its subsidiaries.
5. To promulgate and apply on a consistent basis uniform standards for regulatory and other access issues, such as admission to the NASD as a member firm, and conditions to becoming a market maker; and institute safeguards to ensure fair and evenhanded access to all services and facilities of the NASD.
6. To ensure the existence of a substantial, independent internal audit staff which reviews all aspects of the NASD (including the regulatory function, the disciplinary process and the Nasdaq stock market and its systems) and reports directly to an audit committee of the NASD Board of Governors which includes a majority of public and non-industry Governors and is chaired by a public Governor.
7. To design and implement within the next twenty-four months (or as specified by further order of

the Commission) an audit trail sufficient to enable the NASD to reconstruct markets promptly, effectively surveil them and enforce its rules; which audit trail shall, subject to the Commission's approval, at a minimum, (a) provide an accurate time-sequenced record of orders and transactions, beginning with the receipt of an order at the first point of contact between the broker-dealer and the customer or counterparty and further documenting the life of the order through the process of execution (or partial or non-execution) of that order, and (b) provide for Nasdaq marketwide synchronization of clocks utilized in connection with the audit trail.

8. To improve substantially the surveillance and examination of order handling.
9. To improve substantially the reliability of trade reporting through, among other things, enhancement of surveillance, examination, and enforcement.
10. To upgrade substantially the NASD's capability to enforce the firm quote rule, by (a) implementing a process for backing away complaints to be addressed as they are made during the trading day so that valid complaints may be satisfied with a contemporaneous trade execution; and (b) taking other appropriate actions.
11. To propose a rule or rule interpretation for Commission approval which expressly makes unlawful the coordination by or among market makers of their quotes, trades and trade reports, and which prohibits retribution or retaliatory conduct for competitive actions of another market maker or other market participant.
12. To enforce Article III, Section 1 of the NASD Rules of Fair Practice, with a view to enhancing market maker competitiveness by
  - a. Acting to eliminate anticompetitive or unlawfully enforced or maintained industry pricing conventions, and to discipline market makers who harass other market makers for narrowing the displayed quotations in the Nasdaq market, trading not more than the quantities of securities they are required to trade under the NASD's rules, or otherwise engaging in competitive conduct.



- b. Acting to eliminate coordination between or among market makers of quotes, trades and trade reports.
  - c. Acting to eliminate concerted discrimination and concerted refusals to deal by market makers.
13. To redefine or repeal the excess spread rule so as to eliminate any disincentive to narrow the displayed quotations in the Nasdaq market.
14. To retain an independent consultant, acceptable to the Commission staff, to review and report to the Audit Committee of the NASD Board of Governors on the implementation of these undertakings. The Audit Committee shall report the findings of the independent consultant with respect to such implementation to the Chairman of the NASD Board of Governors and to the Commission's Divisions of Market Regulation and Enforcement beginning six (6) months after the date of this Order and thereafter annually for three years, beginning on the first anniversary of this Order and concluding with the third anniversary of this Order; provided, however, that the appointment and activities of the independent consultant shall in no way limit the lawful authority of the Commission or its staff with respect to the NASD.

By the Commission.

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Jonathan G. Katz  
Secretary